LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS

301 State House
(317) 232-9855

FISCAL IMPACT STATEMENT

LS 6334 | **DATE PREPARED:** Jan 4, 2002
BILL NUMBER: SB 446 | **BILL AMENDED:**

SUBJECT: Phase-out of Inheritance Tax.

FISCAL ANALYST: Jim Landers
PHONE NUMBER: 232-9869

FUNDS AFFECTED: X **GENERAL**
DEDICATED
FEDERAL

IMPACT: State & Local

Summary of Legislation: The bill phases out the Inheritance Tax over a five-year period beginning July 1, 2002, by giving an increasing credit against the Inheritance Tax due. The bill provides that for a person who dies after June 30, 2006, there is no Inheritance Tax imposed. The bill also provides that the Indiana Estate Tax formula does not apply to the estate of a person who dies after December 31, 2004. The bill also makes conforming amendments.

Effective Date: July 1, 2002.

Explanation of State Expenditures: *Department of State Revenue:* Once the Inheritance Tax is repealed, there could be a savings to the state from a reduction in staff in the Inheritance Tax Section of the Department of State Revenue. The January 2, 2002, state manning table indicates that the Inheritance Tax Section has 16 full-time with an annual salary cost of $451,000. Since staff members would still be needed to process returns, a specific savings due to staff reductions could not be estimated.

County Inheritance Tax Replacement: In addition to eliminating Inheritance Tax revenue to the State, the bill would, over the same five-year period, eliminate the resident Inheritance Tax revenue retained by the counties. As a result of the revenue loss, the bill would increase expenditures from the state General Fund relating to the Inheritance Tax replacement for counties. The revenue loss and county replacement payments are summarized in the table below.

Fiscal Year	County Inheritance Tax Loss	State Expenditures for County Replacement
2004	2.0 M	2.0 M
2005	4.0 M	4.0 M
2006	6.0 M	6.0 M
2007	8.0 M	7.5 M
2008 and after	9.9 M	7.5 M

These estimates are based on the Revenue Technical Committee's updated FY 2003 forecast (as of November 14, 2001) for the Inheritance Tax and assume that revenue will remain the same in subsequent years. The impact on the state General Fund in the initial year or two of the phase-out may not equal the revenue loss to the counties since most are retaining more revenue than is guaranteed under the replacement procedure. The net impact of the bill reflected in the table assumes that the revenue loss to the counties will be fully reimbursed by the state until FY 2007 when the county replacement cap equal to roughly $7.5 M is reached. Since the Inheritance Tax does not have to be paid until a maximum of 12 months after the decedent's death (within 9 months of the date of death to receive the 5% early payment discount), the impact that the bill may have is not expected to begin until FY 2004. (See **Explanation of Local Revenues**, below, for further explanation of the replacement procedure.)

Explanation of State Revenues: The bill would lead to a progressively larger reduction in revenue from the Inheritance Tax from FY 2004 to FY 2008, when it is estimated that the state would no longer receive revenue from the tax. In addition, the bill could potentially lead to an increase in revenue from the Estate Tax until FY 2007. This offset by the Estate Tax will decline to zero by FY 2007 due to increases in the federal unified credit and the phase-out of the federal state death tax credit. (Note: Consistent with federal changes, the bill effectively eliminates the Indiana Estate Tax beginning with 2005 decedents.) The estimated impact of the bill on Inheritance Tax and Estate Tax revenue and the net loss to the state including county replacement funding is presented in the table below. The estimates are based on the Revenue Technical Committee's updated FY 2003 forecast (as of November 14, 2001) for the Inheritance and Estate Taxes. They assume that Inheritance Tax revenue will remain the same in subsequent years, but make adjustments to forecasted Estate Taxes to account for the elimination of the Indiana Estate Tax in concert with the repeal of the state death tax credit under the federal Estate Tax.

Fiscal Year	Inheritance Tax Revenues	Estate Tax Revenues	State Expenditures for County Replacement	Net Increase (Decrease)
2004	(23.0 M)	2.6 M	(2.0 M)	(22.4 M)
2005	(46.1 M)	2.0 M	(4.0 M)	(48.1 M)
2006	(69.1 M)	275,000	(6.0 M)	(74.8 M)
2007	(92.2 M)	0	(7.5 M)	(99.6 M)
2008 and after	(115.2 M)	0	(7.5 M)	(122.7 M)

Background on Inheritance Tax: The bill phases out the Inheritance Tax over a five-year period by providing an increasing credit against a transferee's Inheritance Tax liability. The credit would apply to transfers made by persons who die on or after specified dates. The credits and applicable dates are presented in the table below. Since the Inheritance Tax does not have to be paid until a maximum of 12 months after the decedent's death (within 9 months of the date of death to receive the 5% early payment discount), the impact of the first-year credit (equal to 20%) likely would not be experienced until FY 2004.

Inheritance Tax Credit	**Transfers made . . .**
20%	After June 30, 2002 and before July 1, 2003
40%	After June 30, 2003 and before July 1, 2004
60%	After June 30, 2004 and before July 1, 2005
80%	After June 30, 2005 and before July 1, 2006
100%	After June 30, 2006

The estimated revenue loss is based on the Revenue Technical Committee's updated FY 2003 forecast (as of November 14, 2001) for the Inheritance Tax equal to $140.0 M and assumes that revenue in subsequent years will remain the same. The forecast total includes revenue from the Indiana Estate Tax. Based on FY 2001 collections, roughly 17.7% of this total is derived from the Estate Tax. This suggests that Inheritance Tax revenue is forecast at approximately $115.2 M and Estate Tax revenue at about $24.8 M. Thus, the Inheritance Tax revenue loss for FY 2004 and after is estimated based on this forecast.

Background on Estate Tax: The reduction in Inheritance Tax liabilities for some taxpayers could potentially have an impact on Indiana Estate Tax revenues. Indiana Estate Tax is owed on the assets of an estate if (1) federal Estate Tax is owed on the estate and (2) the Indiana portion of the federal state death tax credit (against the federal Estate Tax) exceeds the total Inheritance Tax paid by transferees of the estate. Consequently, for some estates a reduction in the Inheritance Tax liability paid by transferees of the estate results in a compensating increase in the Estate Tax liability.

The estimated impact of the bill on Estate Tax revenues is based on an OFMA database of Estate Tax returns relating to decedents who died between July 1, 1997, and June 30, 2000. The database consists of 559 estates upon which Indiana Estate Tax was paid. Elimination of the Inheritance Tax liability for the sample increased the Estate Tax liability of the sample by a factor of approximately 1.4 for FY 2004, 1.7 for FY 2005, and 1.4 for FY 2006. Based on the updated FY 2003 forecast and accounting for the impact of the recent federal Estate Tax changes, Indiana Estate Tax revenues are estimated to be about $7.0 M in FY 2004, $2.7 M in FY 2005, and $735,000 in FY 2006.The recent federal law changes accelerate the scheduled increase in the unified credit and begin phasing out the state death tax credit in 2002. These estimates are increased by the factors specified above to derive the impact of the Inheritance Tax changes on the Estate Tax.

<u>Explanation of Local Expenditures:</u>

<u>Explanation of Local Revenues:</u> The phase-out of Inheritance Tax is estimated to result in a net revenue loss to counties beginning in FY 2007. The annual impact on the counties is presented in the table below .

Fiscal Year	County Inheritance Tax Revenue	State Expenditures for County Replacement	Net Increase (Decrease)
2004	(2.0 M)	2.0 M	$0
2005	(4.0 M)	4.0 M	$0
2006	(6.0 M)	6.0 M	$0
2007	(8.0 M)	7.5 M	(500,000)
2008	(9.9 M)	7.5 M	(2.4 M)

Counties retain 8% of the Inheritance Tax collected on transfers made by Indiana residents. It is important to note that a reduction in the amount of Inheritance Tax retained by counties due to the bill may be reimbursed by the state under the replacement provision established by P.L. 254-1997. The replacement provision was established when the Class A exemption was increased on July 1, 1997. The replacement provision guarantees that in each fiscal year each county receives an amount under the Inheritance Tax that is equal to the five-year annual average amount of Inheritance Tax revenue retained by that county from FY 1991 to FY 1997, excluding the highest and lowest year. Therefore, a reduction in tax retained by a county due to the bill would be reimbursed only to the extent that the changes made by the bill cause the amount of tax revenue retained by the county to fall below its guaranteed amount. Currently, most counties are retaining more Inheritance Tax revenue than is guaranteed under the replacement procedure. The net impact of the bill assumes that the revenue loss to the counties will be fully reimbursed by the State until FY 2007 when the replacement cap of approximately $7.5 M is reached. A copy of a spreadsheet showing the amount of Inheritance Tax replacement guaranteed to each county under P.L. 254-1997 is available from the Office of Fiscal and Management Analysis.

State Agencies Affected: Department of State Revenue.

Local Agencies Affected: Counties.

Information Sources: State Revenue Forecast, November 14,2001. Bill Reynolds, Indiana Department of State Revenue, 232-2075. OFMA Inheritance and Estate Tax Databases. OFMA County Replacement Spreadsheet.